



# TACKLING THE TAX SYSTEM:

*It's Time to Make It  
Fair, Flat, and Friendly*

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UNITED STATES SENATOR  
**ROD GRAMS**  
MINNESOTA



## *United States Senate*

Dear Minnesota Taxpayers:

When I travel across Minnesota meeting with families, senior citizens, young people just entering the workforce, small business men and women, corporate job providers, and other concerned taxpayers, one question inevitably arises: what is Washington going to do about the tax system? Everyone has a story to tell: one couple's taxes are so high that both spouses are forced to take jobs outside the home; a business owner is threatened by the IRS for nonpayment of taxes he doesn't believe he owes; a farmer wants to pass along the family farm to his children, but the costly and unfair estate tax makes it impossible; an accountant wrestled with tax laws so complex even she feels lost; a family that's already sending one-third of every paycheck to Washington struggles to save for a child's education.

These are real stories that put a human face on the deeply-rooted problems with America's tax system. It's impossible to hear these Minnesotans speak and not understand that something needs to be done — soon.

Through this pamphlet, I'll take an in-depth look at how the government collects your tax dollars and why the system is falling short. I'll examine some of the suggestions being offered to fix the tax collection system and make it more responsive to you, the taxpayers. Most of all, I hope to encourage discussions around the office water cooler and the family dinner table, because it's the taxpayers — through your representatives in Congress — who will ultimately decide how to tackle the tax system. Your voice in the debate is critical.

Sincerely,

A stylized, handwritten signature in blue ink that reads "Rod Grams". The signature is fluid and cursive, with a long, sweeping underline.

Rod Grams  
United States Senator

## THE TAX SYSTEM: AN UNMERCIFUL MESS

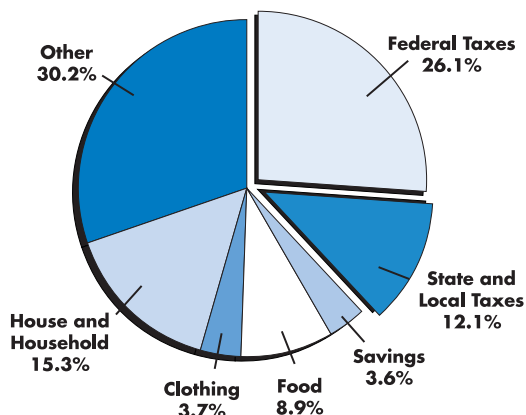
A nationwide debate to reform the tax system is gaining speed. On Tax Day, frustrated Americans tossed all 10,000 pages of the tax code into the Boston Harbor, echoing the Boston Tea Party and the tax-system discontent that spawned a nation. Taxpayers across this country are writing, phoning, and e-mailing their lawmakers, demanding change.

As millions of Americans raced to beat the April 15 tax filing deadline, the spotlight on taxes has focused attention on the underlying motivation for the pursuit of real tax reform: today's tax system is an unmerciful mess!

More than 200 years ago, our ancestors staged a tea party and revolted against their mother country to protest the imposition of unfair taxes. Today, taxes imposed by our own government are unfair by any standard. Had our ancestors faced a tax system as punitive as ours has become, they might very well have jumped into the harbor along with the tea.

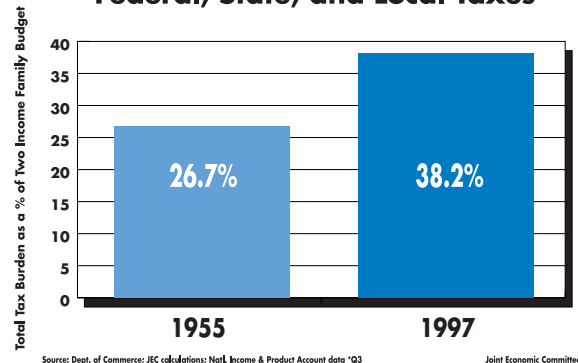
Americans today are working harder but taking home less of their pay. Why? In excess of \$1.7 trillion of their income is siphoned off to Uncle Sam each year. In 1997, total taxes — federal, state, and local — claimed a record 38.2 percent of a typical family's income. Three hours of every eight-hour working day are dedicated just to paying taxes. The total tax burden borne by the American taxpayer in 1998 is the highest in U.S. history.

### Representative Budget of Two-Income Family, 1997



Source: Tax Foundation calculations using Department of Commerce Consumption Duty

## Total Taxes Have Never Been Higher Federal, State, and Local Taxes



The tax system is an unmerciful mess because the earnings, spending, and savings of the American people are taxed over and over to squeeze more money out of their pockets. Income is taxed when it's first earned. The after-tax income is then subject to certain excise taxes when spent. If this after-tax income is saved in a savings account or invested in a business, the interest and profits will be taxed again. If the corporation pays out its after-tax earnings as a dividend to the saver, or if the saver sells his investment, the savings is taxed a third time through a capital gains tax. If the saver dies with some accumulated savings, these savings will be taxed a fourth time through estate and gift taxes. Even after death, one's tax liability lives on.

The tax code itself is an unmerciful mess because it has long been used as a tool for social engineering and income redistribution rather than sound economic policy. As a result, half of the population pays less than 5 percent of all federal taxes while the other half pays more than 95 percent. Clearly, a system of graduated marginal rates violates the principle of fairness. In addition, special interest groups are often unfairly rewarded by the politicians with special tax privileges.

The tax system is an unmerciful mess because it has become extremely complicated and difficult for anyone to understand. The tax code has grown from 14 pages when it was first enacted to more than 10,000 pages today, plus another 20 volumes of tax regulations and thousands of pages of instructions. Even IRS and tax professionals repeatedly make mistakes; IRS agents reportedly give wrong answers to taxpayers about half the time.

The tax system is an unmerciful mess because it's too expensive for the American people. The IRS employs over 102,000 agents to collect taxes, more agents than the FBI and the CIA combined. The taxpayers must pay more than \$8 billion each year to operate the IRS. Worse still, American families, small business



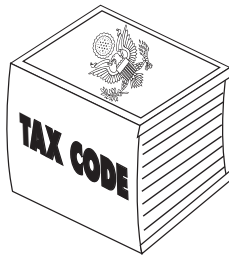
## The Declaration of Independence = 1,300 words

*The Words that defined the moral vision of  
our national government.*



## The Holy Bible = 773,000 words

*The Word of God.*



## The United States Tax Code = 2.8 million words

*The Words that tax our earnings.*

owners, and corporations spend at least \$225 billion attempting to comply with the tax code. If they fail to comply due to innocent mistakes, the IRS penalties could ruin their lives.

The tax system is an unmerciful mess because the IRS has evolved into an arrogant, inefficient, intrusive, and abusive bureaucracy. IRS agents routinely use their enormous, coercive power to squeeze more money out of the taxpayers' pockets to meet the demands of ever-increasing government spending.

Rooted deeply within the system rests the core flaw of the tax system: policymakers care little about how they spend other people's money because the money isn't their own. Now is the time to reverse that thinking. With millions of our citizens demanding real tax reform, Congress must grasp this historic opportunity to deliver change — change that will forever repair the system, honor our great American heritage of individual choice and responsibility, and reflect American values.

The National Tax Reform Commission, led by Jack Kemp, offered six working principles for a new pro-growth, pro-family tax system that would help us to achieve these goals. The principles include:

**Economic growth** through incentives to work, save, and invest;

**Fairness** for all taxpayers;

**Simplicity** so that anyone can figure it out;

**Neutrality** so that people and not government can make choices;

**Visibility** so that people know the cost of government; and

**Stability** so that people can plan for their future.

In sum, the current tax system is an unmerciful mess — but it doesn't need to be. We can and must replace it with a new system that is simpler, fairer, flatter, and friendlier — a better system that will lead this great country into the 21<sup>st</sup> century.

## FIX THE IRS? OR END THE IRS?

Paramilitary-style raids, attempted frame-ups, retaliation against whistleblowers, harassment of innocent individuals, all carried out by a government agency operating outside the bounds of the law and with seemingly limitless authority. A premise played out within the pages of the latest popular novel? Not exactly. These examples, unearthed during recent hearings in the U.S. Senate, are taken directly from the playbook of the Internal Revenue Service.

The hearings, and the abuses they highlighted, have focused the nation's attention on legislation to restructure the IRS that's now making its way through Congress. Included within the legislation are many good provisions that would protect taxpayer rights and restrict the power of the agency. Key provisions would limit interest and penalties on delinquent taxes and shift the burden of proof from the taxpayer to the IRS in tax disputes.

If enacted, these reform provisions would improve IRS service and provide better protections for the taxpayers. Still, a fundamental question remains: can the IRS really be fixed by these reform measures? To answer this, we need to take a closer look into the problems with the IRS.

The passage in 1913 of the 16th Amendment to the Constitution granted Congress the power to impose an income tax. A tiny division of the Bureau of Internal Revenue Service was created to collect the taxes. Eighty-five years later, this division, now known as the IRS, has grown to become the most powerful agency in the entire federal government. The IRS today employs more investigative agents than the FBI and the CIA combined and boasts a total workforce of more than 100,000. It's hard to believe, but more employees work at the IRS than in all but the 36 largest corporations in this country. The decisions IRS bureaucrats make daily affect every American who takes home a paycheck.

The agency's job is to administer and enforce the nation's tax laws and collect tax revenue for the government. To ensure that all Americans pay their taxes, Congress has given the agency almost unlimited power, power that goes beyond the authority granted to any other agency in the federal government. By law, the IRS can audit individuals or businesses. It can impose penalties and impose a lien on or seize a taxpayer's property or bank accounts. Average taxpayers and small business owners have very little administrative or legal remedies against such a powerful agency.

Its unlimited power has made the IRS a wasteful, arrogant, incompetent, intrusive, and abusive agency. The IRS is driven by illegal quotas and collection goals. It has targeted the underprivileged for audits. It has mistreated hundreds of thousands of innocent taxpayers. Clearly, this is an agency out of control, an agency in need of a complete overhaul.

But let's not forget how the IRS reached this troubled point. Congress deserves much of the blame for the present state of our hostile tax system, for it's Congress that created the IRS in the first place. Congress grants the IRS its unlimited power. Congress writes the insane tax code that taxes Americans' income over and over and provides loopholes to thousands of special groups, making the tax code too complicated for most attorneys and accountants to fully understand. Congress requires the IRS to squeeze more tax money out of the taxpayers so that Congress has more to spend. On top of that, Congress ignores its IRS oversight responsibilities. Even while it talks reform, Congress is making the tax code ever more convoluted — since last year, Congress has added 185 new sections and 824 changes to the code.

Most IRS employees are decent, hardworking employees who face an impossible task: interpreting and applying the hundreds of thousands of pages of the tax code and its related regulations. A recent study shows that more than eight million Americans each year receive incorrect bills or refunds due to IRS errors. Each year, *Money* magazine hires 50 professional tax preparers to calculate a return for a sample family. No two preparers have ever had the same result; answers can vary by thousands of dollars. The tax code is confusing and arbitrary,

and this in turn encourages waste, harassment, corruption and abuse.

While it's commendable that both Congress and the Clinton Administration admit there are problems with the IRS and are taking action to address some of them, tinkering with the IRS management plan won't solve the fundamental flaws of the tax system. The real problem with the IRS is neither management nor administration, but the tax code on which all IRS decisions are based. Reform of the IRS without reform of the tax code will send a false signal to the American people that once we've restructured the IRS, all its problems will be solved and there will be no need to reform our tax system. Unfortunately, it's not that easy.

"Reforming" the IRS means scrapping the tax code and replacing it with one that's simpler, flatter, fairer, and friendlier. As a first step, Congress needs to set a date for terminating the tax code, and I'm cosponsoring legislation in the Senate that would do just that. Once we've eliminated the tax code, there will be little, if any, need for the IRS and its playbook of abuse — and real reform will follow.

## THE FLAT TAX: A SIMPLE SOLUTION

As more Americans express their disgust with the current tax system, their calls for real tax reform are growing louder: "Scrap the tax code," they're saying in a unified voice. Congress has heard that message and responded to it recently by passing a resolution to do away with the tax code in 2001. Now, the question is not whether to terminate the code but how to do it.

The flat tax is one of the most popular alternative tax systems being proposed as a replacement for the current tax system. Several variations of the flat tax plan are being debated, but three key features are common to each: under the flat tax, income is taxed at a single, low rate of 17-20 percent for everyone; income is taxed only once; and the system is simple to understand.

The leading flat tax proposal is the one introduced by House Majority Leader Dick Armey and Senator Richard Shelby. Under the Armey-Shelby flat tax plan, individual taxpayers would pay a tax of 17 percent on all wages, salaries, and pensions, but they wouldn't pay taxes on any other income, such as interest, dividends, rents, royalties, and business profits. Since income could be taxed only once, the flat tax would in effect eliminate both capital gains and estate taxes. The flat tax plan also eliminates all deductions and credits. Instead, every working American would receive a generous personal exemption: in a family of four, for example, the first \$33,800 in annual income would be tax exempt.

## Armey-Shelby Flat Tax

- Taxes all income at the single rate of 17 percent.
- Taxes all income once and only once.
- Includes generous personal allowances:  
(\$23,200 per married couple and \$5,300 per child)
- Eliminates the capital gains tax.
- Eliminates the inheritance tax.
- Eliminates the tax on Social Security benefits.
- Immediate 100 percent tax write-off for business expenses.

Businesses would pay a 17 percent tax, the same rate as individual taxpayers. A business would be taxed on only wage payments, pension contributions, and the difference between gross revenue and the sum of purchases from other firms. Pension contributions would be deductible, but there would be no deductions for fringe benefits.

Supporters of the flat tax argue that it's far superior to the current tax system in the following ways:

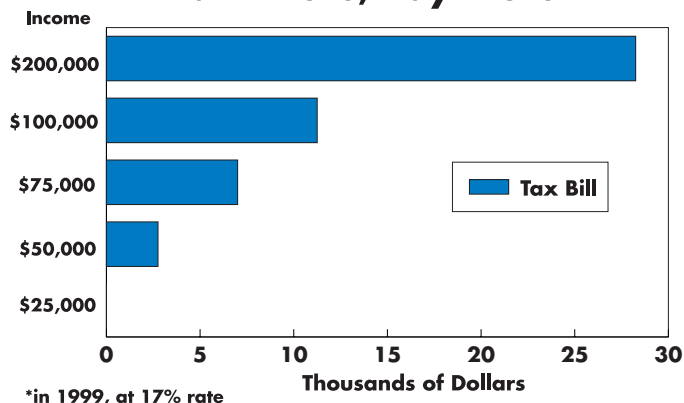
It's flatter. The federal tax burden on working Americans is at an all-time high, as high as 28 percent for the highest-taxed Americans. It's the result of a progressive taxation system designed for the redistribution of wealth. This taxation theory is counterproductive in that it taxes achievement and appears to punish success. A flat 17-percent tax rate, whether it's 17 percent of \$100,000 (\$17,000) or 17 percent of \$10,000 (\$1,700), would raise the necessary revenues while avoiding the distribution of wealth.

It's fairer. Since everyone pays the same tax rate, the system largely treats everyone equally, except for exemptions based on income and family size. There are no tax breaks, preferences for special interests, or loopholes for powerful lobbies.

It's pro growth, pro jobs, and pro-prosperity. Because the flat tax eliminates double taxation on Americans' income, it encourages savings and investment, in turn helping to create new jobs, higher incomes, and faster growth. When marginal tax rates are lower, people will work more, save more, and start more businesses. The flat tax removes nearly all the hurdles for long-term growth for the job providers along Main Street. Stripped of these burdens, U.S. global competitiveness — and the better jobs and higher salaries a healthy, worldwide market represents — will increase.

The flat tax is also simpler. It replaces 480 separate tax forms — and the 280 forms that explain how to fill out those 480 forms — with just two postcard-size forms, one for individual

## Flat Tax Bill Earn More, Pay More



wages and one for business income. The flat tax reduces the costs of complying with today's burdensome tax code by 94 percent, freeing up resources that are currently wasted on record keeping, filing forms, learning the hopelessly complex tax code, and litigation.

The flat tax proposal is not without problems. Although a flat tax system would dramatically reduce the power of the IRS, it would maintain the IRS as the nation's tax law administrator and enforcer. This raises the very real possibility of continued taxpayer abuse and more of the sorts of IRS-created horror stories that recently surfaced during three days of intense, troubling hearings by the Senate Finance Committee.

And the flat tax eliminates current write-offs like the popular mortgage interest deduction. Without any transition period, the loss of the mortgage deduction could create temporary hardship for many American homeowners, although they would benefit from the flat tax in the end.

Form 1 ARMEY-SHELBY FLAT TAX FORM 1999	
Your first name and initial	last name
Your Social Security number	
Present home address	
Spouse's Social Security number	
City, Town or Post Office Box, State and ZIP code	
Your occupation	
Spouse's occupation	
1. Wages, Salary, and Pensions .....	1
2. Personal Allowance .....	2(a)
a. \$23,200 for married filing jointly .....	2(b)
b. \$11,600 for single .....	2(c)
c. \$14,850 for single head of household .....	3
3. Number of dependents, not including spouse .....	4
4. Personal allowances for dependents (line 3 multiplied by \$5300)....	5
5. Total personal allowances (line 2 plus line 4) .....	6
6. Taxable wages (line 1 less line 5, if positive, otherwise zero) .....	7
7. Tax (17 percent of line 6) .....	8
8. Tax already paid .....	9
9. Tax due (line 7 less line 8, if positive) .....	10
10. Refund due (line 8 less line 7, if positive).....	



As former IRS Commissioner Shirley Peterson announced, “We have reached the point where further patchwork will only compound the problem. It is time to repeal the Internal Revenue Code and start over.” Through fundamental reform of the complicated and convoluted tax code, every American will be better off. While the flat tax is just one of several reform proposals being discussed, it’s certainly one of the most feasible solutions to the problems with today’s tax system. As a workable plan that meets the most basic test for any new tax system — that it’s flatter, simpler, and fairer — it deserves a closer look.

### THE NATIONAL SALES TAX: A VIABLE ALTERNATIVE

Imagine for a moment — there’s no federal income tax, no payroll tax, no estate and gift tax, no capital gains tax, no hidden taxes, and no Internal Revenue Service. While this scenario seems hard to imagine, these are the very goals of the tax reform proposal known as the “national retail sales tax” (NRST).

Nothing is new about the idea of an IRS-less society. Our nation operated this way for well over a century, until Congress established the federal income tax in 1913. Unfortunately, the tax system has come a long way — in the wrong direction — since then.

In 1996 alone, the American taxpayers spent more than \$225 billion just to comply with a tax code that has ballooned from 14 pages to over 10,000. Unfortunately, recent congressional hearings revealed such expenditures often don’t protect taxpayers against an abusive IRS. After decades of struggling with a tax system that consumes more than one-third of every paycheck, taxpayers have united behind the call for a simpler and fairer tax code.

Obviously, for any tax replacement proposal to succeed, it must be fair, it must be easy to collect, and it must raise enough revenue to support the necessary activities of the government. With these principles in mind, taxpayers have closely followed the debates between proponents of a flat tax versus the NRST.

#### Principles of the National Retail Sales Tax:

- **You keep 100% of your pay, pension or social security check**
- **We untax the poor and make the necessities tax free**
- **You never file a tax return again**
- **Your family’s finances are not revealed to government bureaucrats**
- **There is no penalty for getting or staying married**
- **Everyone pays their fair share with no loopholes**
- **You can actually understand the tax and how much you’re paying**

Under one of several NRST proposals introduced in the U.S. Congress, a 15 percent sales tax would replace the current income tax system. Workers would no longer have income tax withheld from their paychecks, and would pay taxes only on goods and services actually “consumed.” Consequently, individuals would be empowered to make their own decisions about how much they pay in taxes: those who consume less, pay less.

The Americans for Fair Taxation organization has proposed an alternative NRST “Fair Tax” plan that would eliminate not only personal and corporate income taxes but all payroll taxes as well. To compensate for the difference in revenue, their proposal replaces the current tax system with a 23 percent national sales tax.

Proponents believe the NRST is fair because under it, income would be taxed only when it’s consumed. Since savings and investments represent a deferral in consumption, they would be tax free until those dollars are spent. Furthermore, the government would collect the tax on the value of a good only once. Any item that’s resold would result in a full credit to the seller, thus eliminating double taxation.

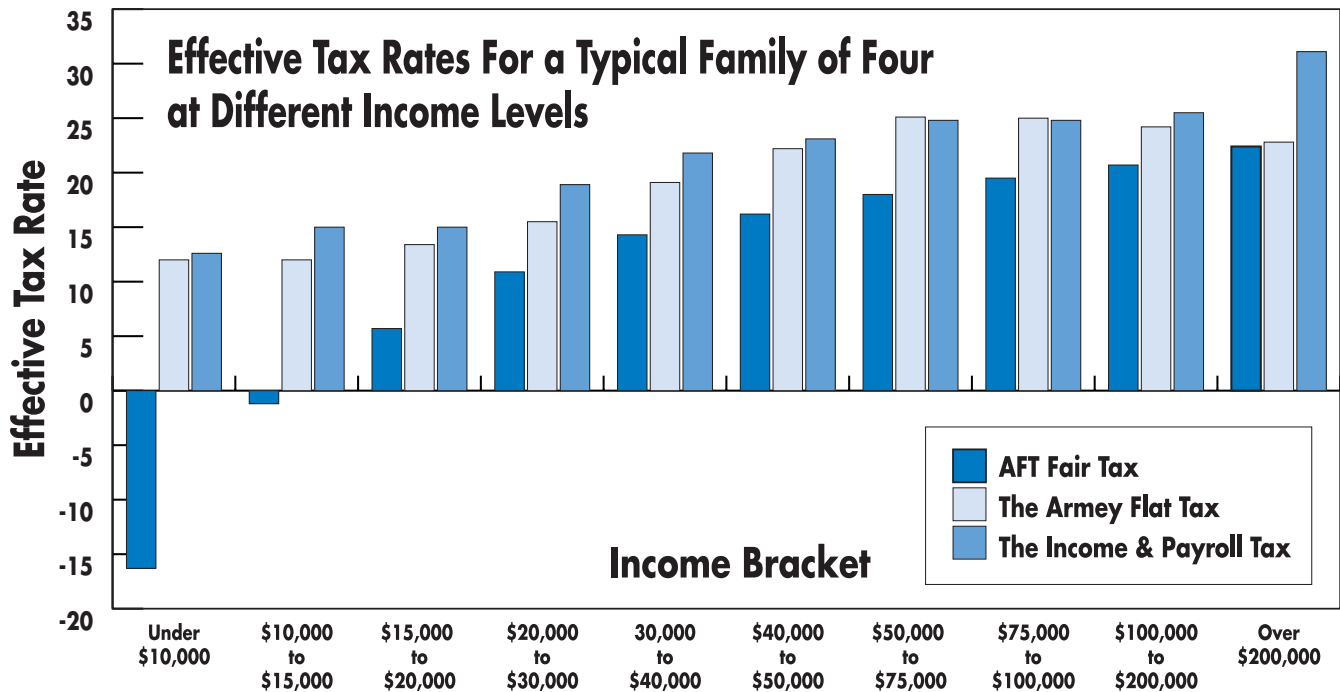
And because all income is ultimately consumed, there’s no inequity between income levels. Under a national sales tax, there would be no loopholes or exceptions that would allow wealthier individuals to shelter their income. When income is spent, it’s taxed. The more income is consumed, the more tax is paid.

To ensure that the basic necessities of life remain tax free, every wage earner would receive a “credit” equal to the NRST rate times the poverty level, meaning every worker would earn up to the poverty level tax free. Those earning under the poverty rate would pay no taxes at all.

While some might argue that not having a business pay taxes is unfair, it’s important to recognize that under the current system, businesses don’t truly pay taxes anyway — they merely pass their taxes along to consumers through higher prices, reduced wages for their workers, or reduced returns to investors. By eliminating these “hidden taxes,” prices will go down and consumers will be able to make buying decisions based upon the real value of a good or service.

Collection of the NRST could be accomplished without an IRS by administering it primarily at the state level. Forty-five states already have a collection mechanism in place. For states without a sales tax, like Oregon, they could contract with a state that does.

In order to succeed, every tax replacement proposal must adequately fund the necessary activities of the government, but



This chart contrasts effective tax rates, for a typical family of four at different income levels, under AFT Fair Tax, the Army Flat Tax, and current law. The effective tax rates were calculated using the median income for each income bracket. The Flat Tax effective rate includes the individual level wage tax and the business level tax on capital income. In addition, the assumption was made under The Fair Tax that all income was spent. This representation is based on 1992 data and includes both the employee and employer portions of their payroll tax. Most economists consider that it is really the employee that pays the matching employer portions of Social Security and Medicare payroll taxes through lower wages. The chart reveals the highly progressive nature of the AFT Fair Tax and shows under current tax law, wage earners who earn under \$10,000 annually have an effective tax rate of 12.6%, under the Flat Tax they will have nearly the same effective rate, but under The Fair Tax, these same wage earners will have a negative effective tax rate of -16.3%.

it can't be so oppressively high that it stifles the economy. The Schaeffer-Tauzin proposal, one of the most popular NRST plans, proposes a 15 percent rate for all consumer spending. If we applied this tax rate to consumer spending data for 1994, the resulting revenue under the NRST exceeds the total amount of personal and corporate income tax, capital gains tax, estate and gift tax, and most excise taxes collected by some \$125 billion. Furthermore, by not collecting taxes on savings while they're invested, the economy is allowed to prosper, creating more jobs, more consumers, and ultimately, more revenues.

It's important to note, though, that the more exemptions that are adopted in conjunction with the NRST, the higher the end rate will be. In addition, granting "credits" for certain products or individuals further complicates the simplicity of any tax code.

Critics also suggest that the NRST rates would be too high, increasing the possibilities of widespread tax evasion by creating a black market economy. If that happened, the tax would be virtually uncollectible. Proponents argue that the increased fairness, transparency, and legitimacy of the national sales tax would reduce rather than increase tax evasion.

Fair, simple to collect, and revenue rich, the NRST represents a workable solution when the time comes to scrap the current tax code. Based on the growing call from the public for reform, the time for making a change is quickly approaching. ■

## CONCLUSION

Your input is vital to the success of these and other initiatives Congress may consider, and, as always, I encourage you to contact me with your comments and suggestions.

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